No. 10,739

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

SPRECKELS-ROSEKRANS INVESTMENT COMPANY (a corporation),

Appellant,

vs.

JOHN V. LEWIS, former Collector of Internal Revenue of the United States for the First District of California,

Appellee.

APPELLANT'S REPLY BRIEF.

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APPELLEE'S POINTS.

The appellee in his brief makes two points in support of the affirmance of the judgment below: (1) that the taxpayer's investment being single, gain or loss may be determined only when the entire investment is sold, and (2) that neither the statute nor the regulations provide for the allocation of the costs of units of bank-securities affiliate stocks between the two. These two points will be answered in the order in which they were advanced.

I. THE FACT THAT AN INVESTMENT IS SINGLE AND THE COST UNALLOCATED BY THE TAXPAYER IS INOPERATIVE TO CONTROL THE RECOGNITION OF GAIN OR LOSS WHEN SUBSEQUENTLY THE INVESTMENT CEASES TO BE SINGLE AND THE COST CAN BE ALLOCATED.

Appellee argues that since the taxpayer made a single and unallocated investment, it cannot claim a loss when subsequently the investment ceases to be single and the cost can be allocated, relying upon the authority of the case of *deCoppet v. Helvering,* 108 F. (2d) 787. While it is true that this reason was assigned for the affirmance by the Circuit Court of Appeals of the Board of Tax Appeals' decision in the deCoppet appeal, it was not the basis for the decision of the Board which had held that the taxpayer could not claim a loss on the liquidation of a bank affiliate which was dissolved without assets and without distribution of its shares because of the involved transactions surrounding the acquisition of the interests by the taxpayer. And while it is true that the Circuit Court of Appeals for the Second Circuit said that it was unable to distinguish between the issues involved in the *Hagerman* and *deCoppet* cases, the Circuit Court of Appeals for the Third Circuit, in *Wise v. Commissioner,* 109 F. (2d) 614, involving the same decision of the Board, the appeal of Wise having been consolidated with the appeal of deCoppet for trial before the Board, likewise affirmed, but found no conflict with the Hagerman decision.

The Commissioner of Internal Revenue would be the last person to urge that because a taxpayer had purchased, as a unit, land, buildings and machinery

constituting a single factory, and had failed to make any allocation on his books of the cost as between land, buildings or machinery, no such allocation could be made upon the future disposition of separate portions of the factory. The sole purpose throughout the statute and the regulations of providing for allocations is because the investments in the first instance are single and unallocated; otherwise there would be no occasion for the provisions, and it is idle to argue that allocation cannot be made merely because the investment is single.

Furthermore, if appellee is right in regarding the purchase transaction as the acquisition of a single investment or unitary interest, it then follows that upon the termination of that character and the receipt by appellant of two separate stocks (300 shares of Bank stock and 30 shares of Amerex stock), the base date must be the date of such reissue and the values at that date furnish the basis of apportionment, for the situation is then analogous to that which arises when upon reorganization two different classes of stock are received for the surrender of a stock previously held. That being the character of the transaction, the respective values as of the date of the reissue are furnished by actual market quotations (R. 14-15), and the ratio becomes 95% of cost for the Bank stock and 5% for the former Securities stock. This aspect of the case will be discussed later.

It is submitted that appellee's argument under this head does not answer the problem before the Court, but merely begs it.

II. THE COST OF THE UNITS OF BANK AND SECURITIES STOCK CAN BE APPORTIONED.

(a) The statute requires the recognition of gain or loss unless otherwise expressly provided.

Appellee first argues that apportionment cannot be made between the Bank and the Securities stock because there is no authority therefor either in the statute nor in the regulations. His argument fails at the outset through his ignoring the provision of section 112 of the Revenue Act of 1936, which provides:

> "(a) **General Rule.**—Upon the sale or exchange of property the entire amount of the gain or loss determined under section 111 shall be recognized except as hereinafter provided in this section."

The statute being general, the loss must be recognized unless the statute specifically provides for a postponement of such recognition. The statute nowhere so provides. It follows that if an apportionment is necessary in order that a loss may be recognized, such apportionment is required. Appellee, in a note on page 17 of his brief, quotes from a portion of Article 1567 of Regulation 62, providing for the allocation of cost where securities of a single class are exchanged for securities of different classes, so that no gain or loss is realized, the following language:

> "If no fair apportionment is practicable, no *profit* on any subsequent sale of any part of the property received in exchange is realized until out of the proceeds of sale shall have been recovered the entire cost of the original property." (Emphasis supplied.)

A similar provision is contained in Article 22(a)-8 of Regulations 94, under the 1936 Act, relating to the receipt of common stock as a bonus on the purchase of preferred stock.

> "Art. 22(a)-8. *Sale of stock and rights.*— * * * If common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such common stock and the securities purchased for the purpose of determining the portion of the cost attributable to each class of stock or securities, *but if that should be impracticable in any case, no profit on any subsequent sale of any part* of the stock or securities will be realized until out of the proceeds of sales shall have *been recovered the total cost.*" (Emphasis supplied.)

In both instances it will be noted that the general rule announced is that the original cost or total purchase price is to be allocated or fairly apportioned between the resulting stocks and that only in the event such apportionment is found to be impracticable "*no profit* on any subsequent sale * * * is realized" until the entire cost of the original property is recovered. Nothing is said about the recognition of *loss*. In view of the positive provision of section 112 of the Revenue Act of 1936 that loss shall be recognized and the meticulous care with which the Treasury Regulations are drafted, it cannot be assumed that the failure to include *losses* in the articles referred to was unintentional, so that exception to the rule announced in the articles is by their own language absolutely inapplicable to the present case where a loss is involved.

Appellee makes the mistake in referring to the various regulations cited by appellant upon the subject of the possibility of apportionment in assuming and arguing that appellant relies upon these sections as supporting, by analogy, the right to apportionment in the present case. These sections are cited not as controlling the right to apportionment, but as showing that the practice of apportionment of cost runs throughout the entire body of the revenue law, and that where a taxpayer establishes a basis for apportionment he is entitled to such apportionment, if necessary, for the proper determination of his income tax liability.

(b) Appellee's evidence supported apportionment.

Appellee questions the sufficiency of appellant's evidence to support apportionment in the present case and cites the fact that while the evidence in support of the refund claim based upon comparative earnings and net worth of the Bank and its affiliate resulted in an allocation of 70% of cost to the Bank stock, and 30% to the affiliate, the testimony of Montgomery resulted in an allocation of 75% to the bank and 25% to the affiliate. Appellee does not question the qualification of Montgomery to give expert testimony as to the value of the component stocks at the date of acquisition, and the fact that his method of valuation based upon dividends so closely approximates the result obtained by the method of comparison of earnings and net worth supports rather than detracts from the weight of his testimony. Montgomery was giving an apportionment on the only basis that an

individual buyer of 300 units could use, since it is obvious, as was pointed out in the opening brief (p. 40), that a small investor cannot have an appraisal made of the assets of a bank and its affiliate, or an audit made of its earnings.

Nor is it any answer to Montgomery's testimony to characterize it as "guessing". (Appellee's Brief, p. 22.) After all, that term can be applied to all opinion evidence of value not based on actual sales, and yet it is established beyond contradiction that such evidence can and *must* be accepted where proof of value is necessary to the determination of legal rights. The Supreme Court in *United States v. Miller,* 317 U. S. 369, 374, 63 S. Ct. 276, 279, 87 L. ed. 336, 343, reviewing a condemnation award and speaking of opinion evidence, says:

> "Where, for any reason, property has no market resort must be had to other data to ascertain its value; and, even in the ordinary case, assessment of market value involves the use of assumptions, which make it unlikely that the appraisal will reflect true value with nicety. It is usually said that market value is what a willing buyer would pay in cash to a willing seller. *Where the property taken, and that in its vicinity, has not in fact been sold within recent times, or in significant amounts, the application of this concept involves, at best, a guess by informed persons.*" (Emphasis supplied.)

Such being the case the Trial Court, having before it the uncontradicted testimony of a qualified witness as to value, cannot disregard such testimony or evade a decision as to the values testified to by a finding that

apportionment was impracticable. It is submitted that for the purposes of this case it is established that the respective bases of the two stocks at the dates of acquisition were 75% of the cost for the bank stock, and 25% for the securities stock.

(c) Hagerman case not the only authority for apportionment.

On pages 17 to 26 of its opening brief, appellant has discussed the right to apportion cost or other basis of property acquired as a single investment in the determination of liability for federal income taxes and has there demonstrated that the cases in which such apportionment was refused, being the cases relied upon by appellee in his brief, are clearly distinguishable from the *Hagerman* case in that the testimony was insufficient for some reason or other to furnish the basis for such apportionment. In that connection an interesting sidelight on human nature is found in the fact that where a taxpayer is claiming a loss under the circumstances similar to those in the present case, the Commissioner of Internal Revenue almost uniformly argues that apportionment is improper or impracticable, while, when a profit arises from such a transaction, he is quite as positive that apportionment is both proper and practicable.

Typical of such cases is *Taylor v. Commissioner,* 70 F. (2d) 619 (affirmed: *Helvering v. Taylor,* 293 U. S. 507, 79 L. ed. 623), cited by the appellee, where the taxpayer had acquired in 1927 an entire issue of preferred and two classes of common stock in a holding company at a cost of $96,000. In 1928 the holding com-

pany sold its assets for $195,000 and thereupon retired the preferred stock for $99,000, leaving $96,000 in the treasury. The Commissioner allocated $49,000 as the basis of the preferred shares and determined that the taxpayer was taxable on a gain of $47,000. The Circuit Court of Appeals (for the Second Circuit) *held the Commissioner's allocation of cost unreasonable,* but, after quoting from Article 58, Regulations 74, identical in language to Article 22(a)-8 of Regulations 94 under the 1936 Act, *supra,* said, page 620:

> "Nevertheless, while we think that the finding of the Commissioner was wrong, it does not follow that any allocation of the original consideration was 'impracticable'."

The decision of the Board of Tax Appeals was reversed and remanded for a determination of a proper allocation.

Likewise, in the *Appeal of Bancitaly Corporation,* 34 B.T.A. 494, where the taxpayer claimed the right to await determination of profit until all of a certain block of stock was sold, the Board, supporting the Commissioner's insistence on apportionment of cost and reporting of profit on sales of various parcels, says, page 504:

> "Collectively these shares represented petitioner's investment in the consolidated bank. That this investment, or a large portion of it, was disposed of piecemeal is an inevitable conclusion upon the facts. It is well settled that where property is acquired *en block* or *en masse* and subsequently sold in lots or parcels, a computation of

> gain or loss must be made upon each separate sale and the result reported in the tax return and not held in abeyance or suspense until the entire cost of the property is recovered. *Santa Maria Gas Co.,* 10 B.T.A. 1412; *Weser Bros. Inc.,* 12 B.T.A. 1394; *American Industrial Corporation,* 20 B.T.A. 188; and *O. H. Himelick,* 32 B.T.A. 792."

Again, in *Houghton v. Commissioner,* 71 F. (2d) 656, discussed in appellant's opening brief, page 26, the Commissioner had assessed a tax on the *profit* realized by the taxpayer from the sale of preferred stock received on a tax free exchange with common stock, apportioning the cost basis of the two classes of stock according to their respective values. The taxpayer contended that apportionment was impracticable and that no profit was realized until the entire cost of the original property had been recovered, relying on Article 1567 of Regulations 62, which on this point reads substantially as does Article 22(a)-8 of Regulations 94, *supra.* The Court affirmed the order of the Board of Tax Appeals approving the action of the Commissioner in making the apportionment. The same situation existed in *Salvage v. Commissioner,* 76 F. (2d) 112, 114 (affirmed: *Helvering v. Salvage,* 297 U. S. 106, 80 L. ed. 511), where the taxpayer opposed the Commissioner's action in making an apportionment between preferred and common stock to determine a profit. The Court again held such apportionment proper under the Regulations.

On the other hand, *in Curtiss v. Commissioner,* 21 B.T.A. 629, 636, affirmed 57 F. (2d) 847, 848-9, where

the taxpayer claimed a *loss* on the sale of stock acquired with other stock on a tax free exchange, the Commissioner unsuccessfully asserted that apportionment was "impracticable" and that the loss must be deferred until all the stock was sold.

As heretofore stated and as pointed out in appellant's opening brief, all of the cases involving loss claimed on the sale of components of bank and affiliate units in which the right to take such loss is denied can be reconciled with the *Hagerman* case, and that case must be considered as controlling in the decision of the present case since appellant in its proof in the Trial Court has avoided the errors which defeated recovery in the cases in which such losses were denied.

(d) Refund claim sufficiently broad to support recovery either on apportionment as of date of acquisition or as of date of termination of unitary character of stocks.

A note at the foot of page 26 of appellee's brief suggests that appellant cannot claim an apportionment as of the date of the removal of the restrictions on the separate transfer of the stock since the point was first raised on appeal and was not presented in the claim for refund. The point was raised in argument to the Trial Court. (Plaintiff's Opening Brief to the Trial Court, pages 28 and 29.) Furthermore, the market prices of the two stocks at that date were incorporated in the stipulation of facts without reservation of objection thereto. (R. 14-15.) The ground for recovery of the tax involved was stated in the refund claim, as follows:

> "This taxpayer contends that it is appropriate and feasible to make a fair allocation of the cost of the Chase Bank units between the Chase National Bank stock which was sold and the Amerex Holding Corporation stock which was retained." (R. 29.)

This is the identical ground asserted in the complaint and argued to the Trial Court and this Court. It is the ground to which appellee's brief is devoted. The ground of recovery remaining the same, the taxpayer is entitled to present any relevant evidence in support thereof, whether or not set forth in the refund claim.

Paul Jones & Co. v. Lucas, 33 F. (2d) 907, 908;
Biermann v. Shea, 28 F. Supp. 213, 215;
F. W. Fitch Co. v. United States, 52 F. Supp. 292, 296.

CONCLUSION.

In conclusion, it is submitted that:

1. Under the prevailing and general rule gain or loss is to be recognized on the sale of property acquired with other property at a unit cost price;

2. Appellant established that the unit cost of the Chase Bank and Chase Securities stock acquired by it can be *fairly apportioned* on a basis of 75 to 25, or of 95 to 5, depending upon the date chosen for apportionment;

3. Appellee did not show here that (a) it is *impracticable* to apportion the cost of the units, or (b) that appellant's apportionment is not fair.

The judgment below should be reversed with instructions to the Trial Court to determine a fair apportionment of the cost between the two stocks and order judgment for appellant accordingly.

Dated, San Francisco, California,
September 11, 1944.

Respectfully submitted,
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